INDEX

	Page
Record from The Tax Court of the United States	1
Docket entries	1
Agreed statement of facts	2
Exhibit 1-A—Excerpts from indenture dated September 1, 1941	4
Findings of fact and opinion, Opper, J	9
Decision	14
Statement of points to be relied upon	15
Proceedings in U. S. C. A., Second Circuit	16
Opinion	16
Judgment	21
Petition for rehearing	23
Opinion on petition for rehearing	31
Order denying petition for rehearing	33
Clerk's certificate	33
Order allowing certiorari	34

27

APPENDIX

The Tax Court of the United States

Docket No. 13943

CHRISTIAN W. KORELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Entries

[Tr. 1]

1947

May 13. Petition received and filed. Taxpayer notified. Fee paid.

May 14. Copy of petition served on General Counsel.

Jun. 18. Answer filed by General Counsel.

Jun. 18. Request for hearing at New York City filed by General Counsel.

Jun. 20. Notice issued placing proceeding on New York City calendar. Service of answer and request made.

No. 18 Hearing set Dec. 8, 1947, at New York City.

Dec. 8. Hearing had before Judge Opper on merits. Submitted. Agreed statement of facts (with joint exhibit 1-A attached) filed. Petitioner's brief due 1/7/48—respondent's 2/6/48 reply 2/24/48.

Dec. 30. Transcript of hearing of 12/8/47 filed.

1948

Jan. 2. Motion for extension to Jan. 17, 1948, to file brief filed by taxpayer. Granted.

Jan. 19. Brief filed by taxpayer—copy served.

Feb. 18. Motion for extension of 15 days to file brief filed by General Counsel. 2/19/48 granted.

Mar. 4. Brief filed by General Counsel.

28 1948

Mar. 24. Motion for leave to file the attached reply brief, brief lodged, filed by taxpayer. 3/25/48 granted.

Mar. 25. Petitioner's brief served on General Counsel.

Jun. 2. Findings of fact and opinion rendered, Opper J. Decision will be entered under Rule 50. Copies served 6/3/48.

Jul. 2. Computation of deficiency filed by General Counsel. Agreed to.

Jul. 13. Decision entered, Opper J. Div. 14.

Oct. 8. Petition for review by U. S. Court of Appeals, 2nd Circuit, filed by General Counsel.

Oct. 8. Notice of filing petition for review on Paul L. Peyton, counsel for taxpayer, filed.

Oct. 19. Proof of service filed (Paul L. Peyton).

Nov. 15. Motion for extension of time to Jan. 6, 1949 to prepare and transmit record filed by General Counsel.

Nov. 15. Order enlarging time to Jan. 6, 1949 to prepare and transmit record entered.

Dec. 28. Statement of points with proof of service thereon filed by General Counsel.

Dec. 28. Designation of contents of record on review with proof of service thereon filed by General Counsel.

* * * * *

Agreed Statement of Facts

[Tr. 11-14]

[Caption omitted]

It is hereby stipulated and agreed, by and between Christian W. Korell and the Commissioner of Internal Revenue, by their respective attorneys, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not at variance with the facts herein stipulated
29 and without prejudice to the right of either party to question the materiality of the facts herein stipulated:

1. The petitioner is an individual residing in New York, N. Y., and having an office at 50 Broadway, New York 4, N. Y.

2. During 1944, the petitioner purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% Convertible Debenture Bonds due September 1, 1956, as follows:

August 16, 1944—$11,000 at 121⅛	$13,351.25
August 16, 1944— $2,000 at 121	2,425.00
August 22, 1944—$37,000 at 121¼	44,862.50

The average price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share and on August 22, 1944, $163.6875 per share.

3. The aforesaid bonds were issued under an Indenture between the American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941, a

true and correct copy of which is marked Exhibit 1-A and attached hereto and made a part hereof. The entire issue of the aforesaid bonds was called under the provisions of the Indenture (Exhibit 1-A) for payment as of September 1, 1947, at 104 plus interest.

4. The petitioner duly filed his return for the calendar year 1944 with the Collector of Internal Revenue for the Second District of New York and in said return claimed as a deduction in computing net income amortization of the premium paid with respect to the aforesaid bonds in the amount of $8,638.75, representing the difference between $60,638.75, the cost of the bonds as aforesaid, and $52,000, the call price thereof as set out in the attached Indenture marked Exhibit 1-A.

5. The aforesaid bonds, listed under paragraph "2" hereof, were the only premium bonds purchased or owned by the petitioner in the year 1944.

30 6. The bonds purchased by the petitioner were not part of the stock-in-trade of the petitioner, or includible in any inventory of the petitioner at the close of the taxable year, or held by the petitioner primarily for sale to customers in the ordinary course of his trade or business, but were purchased by the petitioner as an investment. The petitioner did not, during the calendar year 1944, sell any of the bonds purchased by him, as aforesaid, nor did he exercise his privilege of converting said bonds into Capital Stock of the Company.

7. In determining the deficiency herein, the Commissioner disallowed the aforesaid deduction of $8,638.75, representing amortization of bond premium claimed by petitioner as a deduction in his income-tax return for 1944.

Dated: December 5, 1947.

PAUL L. PEYTON,
Counsel for Petitioner.

(Signed) CHARLES OLIPHANT,
RPH.
Chief Counsel, Bureau of Internal Revenue.

31 *Excerpts From Indenture Dated September 1, 1941*

(Exhibit 1-A)

[Tr. 15]

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

AND

CITY BANK FARMERS TRUST COMPANY, TRUSTEE

Indenture dated September 1, 1941

* * * * *

[Tr. 52–53]

Section 3.01. The Company may, at its option, redeem all or from time to time any part of the Debenture Bonds on any date on or after September 1, 1942, and prior to maturity at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter 100%.

* * * * *

[Tr. 56–57]

Section 4.01. The holder of any Debenture Bond or Debenture Bonds shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or De-
32 benture Bonds), to convert, subject to the terms and provisions of this Article, the principal of any such Debenture Bond or Debenture Bonds into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond or Debenture Bonds surrendered for conversion is a multiple of $100 (such amount of $100 or, in case of any adjustment of such amount pursuant to the provisions of Section 4.05, then such adjusted amount, being hereinafter referred to as the "basic bond price") at the price of $140 per share (such amount of $140, or, in case of any adjustment of such amount pursuant to the provisions of Section

4.04, then such adjusted amount, being hereinafter referred to as the "conversion price") upon (i) payment to the Company for each such share of Capital Stock of cash in an amount equal to the amount by which the conversion price exceeds the basic bond price and (ii) surrender of the Debenture Bond or Debenture Bonds the principal of which is so to be converted to the Company at the office or agency to be maintained by the Company in accordance with the provisions of Section 5.02, will all unmatured coupons, if any, thereto appertaining, and, in the case of registered Debenture Bonds without coupons and of coupon Debenture Bonds which shall at the time be registered as to principal, accompanied by instruments of transfer in form satisfactory to the Company, duly executed by the respective registered holders thereof or by their duly authorized attorneys. For convenience, the conversion of the principal of any Debenture Bond or Debenture Bonds into the Capital Stock of the Company is hereinafter sometimes referred to as the conversion of such Debenture Bond or Debenture Bonds.

* * * * * *

33 [Tr. 59–64]

Section 4.04. The conversion price specified in Section 4.01 shall be subject to adjustment from time to time as follows:

A. In case the Company shall at any time after the date of the execution of this Indenture (1) issue any shares of Capital Stock (other than upon conversion of the Debenture Bonds) without consideration, as a dividend or otherwise, or for a consideration per share less than the conversion price in effect immediately prior to the issuance of such additional shares or (2) declare any dividend, other than a dividend payable in cash or in shares of Capital Stock of the Company, then, and thereafter successively upon each such issuance and each such dividend declaration, the conversion price in effect immediately prior to the issuance of such additional shares or the declaration of such dividend, shall forthwith be reduced to a price determined by dividing

(1) an amount equal to (a) the total number of shares of Capital Stock outstanding immediately prior to such issuance or the declaration of such dividend multiplied by the conversion price in effect immediately prior to such issuance or the declaration of such dividend, plus (b) the consideration, if any, received by the Company upon such issuance or less (c) the aggregate of the amount of such dividend then being declared, by

(2) the total number of shares of Capital Stock outstanding immediately after the issuance of such additional shares or the declaration of such dividend.

Anything in this Article Four to the contrary notwithstanding, the Company shall not be required to make any adjustment of the conversion price in any case in which the amount by
34 which such conversion price would be reduced in accordance with the foregoing provisions of this Section 4.04 would be less than $2.00 (or, in the event of any adjustment of the basic bond price pursuant to Section 4.05, such other amount as is in the same proportion to the adjusted basic bond price as the amount of $2.00 is to the original basic bond price of $100), but in such case any adjustment or adjustments so carried forward, shall amount shall be carried forward and shall be made at the time of and together with the next subsequent adjustment, which, together with any adjustment or adjustments so carried forward, shall amount to not less than $2.00 or not less than such other amount as shall then be in effect.

For the purposes of this Subdivision A, the following provisions shall also be applicable:

(1) In case of the issuance of additional shares of Capital Stock for cash, the consideration received by the Company therefor shall be deemed to be the amount of cash received by the Company for such shares, before deducting therefrom any commissions or other expenses paid or incurred by the Company for any underwriting of, or otherwise in connection with, the issuance of such shares.

(2) In case of the issuance (otherwise than upon conversion or exchange of obligations or shares of stock of the Company) of additional shares of Capital Stock for a consideration other than cash or a consideration a part of which shall be other than cash, the amount of the consideration other than cash received by the Company for such shares shall be deemed to be the value of such consideration as determined by the Board of Directors.

(3) In case of the issuance of additional shares of Capital Stock upon conversion or exchange of any obligations or of any shares of stock of the Company that shall be convertible into or
35 exchangeable for shares of Capital Stock, the amount of the consideration received by the Company for such additional shares of Capital Stock shall be deemed to be the amount of the consideration received by the Company upon the original issuance of such obligations or shares so converted or exchanged, plus the consideration, if any, other than such obligations or shares, received by the Company upon such conversion or exchange, except in adjustment of interest and dividends. The amount of the consideration received by the Company upon the original issuance of such obligations or shares so converted or exchanged and the amount of the consideration, if any, other than such obligations or shares, received by the Company upon such conversion

shall be determined in the manner provided in paragraphs (1) and (2) above; provided, however, that if such obligations or shares of stock so converted or exchanged shall have been issued as a dividend upon any stock of the Company, the amount of the consideration received by the Company upon the issuance of such additional shares of Capital Stock shall be deemed to be the value of such obligations or shares of stock, as of the date of the adoption of the resolution declaring such dividend, as determined by the Board of Directors of the company at or as of that date, plus the consideration (determined in the manner provided in paragraphs (1) and (2) above), if any, other than such obligations or shares, received by the Company upon such conversion or exchange, except in adjustment of interest and dividends.

(4) In case of the issuance of additional shares of Capital Stock as a dividend, the aggregate number of shares of Capital Stock issued in payment of such dividend shall be deemed to have been issued on the record date fixed for the determination of stockholders entitled to such dividend and shall be deemed to have been issued without consideration.

36 (5) The amount of a dividend in property (including obligations of the Company) or in shares of stock (other than Capital Stock of the Company) shall be deemed to be the value of such property or shares of stock, as of the date of the adoption of the resolution declaring such dividend, as determined by the Board of Directors of the Company at or as of that date.

(6) The term dividend shall mean a dividend or other distribution upon stock of the Company.

(7) The number of shares of Capital Stock at any time outstanding shall include all shares of Capital Stock then owned or held by or for the account of the Company.

B. In case the Company shall at any time subdivide the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the conversion price in effect immediately prior to such subdivision shall be proportionately decreased, and in case the Company shall at any time combine the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the conversion price in effect immediately prior to such combination shall be proportionately increased.

C. Whenever the conversion price is adjusted, as herein provided, the Company shall forthwith file with the Trustee a statement signed by the President or a Vice-President of the Company and by its Treasurer or an Assistant Treasurer, showing in detail the facts requiring such adjustment, and the adjusted conversion price determined as provided herein. Subject to the provisions of Section 8.01 hereof, the Trustee shall be under no duty or responsi-

bility with respect to any such statement except to exhibit the same from time to time to any bondholder desiring an inspection thereof.

37 Section 4.05. The basic bond price specified in Section 4.01 shall be subject to adjustment from time to time as follows:

A. In case any adjustment of the conversion price pursuant to Subdivision A of Section 4.04 shall result in the reduction of the conversion price to an amount less than the basic bond price in effect immediately prior to such reduction of the conversion price, then, and thereafter successively in the case of each reduction of the conversion price pursuant to said Subdivision A, the basic bond price in effect immediately prior to such reduction of the conversion price shall forthwith be reduced to an amount which shall be equal to the conversion price as so reduced.

B. In case the Company shall at any time subdivide the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the basic bond price in effect immediately prior to such subdivision shall be proportionately decreased, and in case the Company shall at any time combine the outstanding shares of the particular class of Capital Stock into which the Debenture Bonds are convertible, the basic bond price in effect immediately prior to such combination shall be proportionately increased.

C. Whenever the basic bond price is adjusted, as herein provided, the Company shall forthwith file with the Trustee a statement signed by the President or a Vice-President of the Company and by its Treasurer or an Assistant Treasurer, showing in detail the facts requiring such adjustment, and the adjusted basic bond price determined as provided herein. Subject to the provisions of Section 8.01 hereof, the Trustee shall be under no duty or responsibility with respect to any such statement, except to exhibit the same from time to time to any bondholder desiring an inspection thereof.

* * * * *

38 [Tr. 68–69]

Section 5.02. As long as any of the Debenture Bonds remain outstanding, the Company will maintain an office or agency in the Borough of Manhattan, The City of New York, where the Debenture Bonds may be presented for registration, transfer, exchange and conversion as in this Indenture provided, and where notices and demands to or upon the Company in respect of the Debenture Bonds and coupons or of this Indenture may be served,

and where the Debenture Bonds and Coupons may be presented for payment. The Company will give to the Trustee notice of the location of any such office or agency and of any change of location thereof. In case the Company shall fail to maintain such office or agency or shall fail to give such notice of the location or of any change in the location thereof, presentations and demands may be made and notices may be served at the principal office of the Trustee in the Borough of Manhattan, the City of New York.

* * * * *

Findings of Fact and Opinion

[Tr. 138–142]

[Caption omitted]

* * * * *

This proceeding was brought for a redetermination of a deficiency in income tax for the year 1944 in the amount of $5,218.84. Minor adjustments have been conceded by petitioner and the litigated issue is whether respondent erred in disallowing the deduction claimed by petitioner in the taxable year under Internal Revenue Code, sections 23 (v) and 125, as amortization of the premium over the call-price of certain bonds.

39 *Findings of Fact*

All the facts are stipulated and are hereby found accordingly.

Petitioner, an individual, filed his income-tax return for the period in question with the collector of internal revenue for the second district of New York.

During 1944 petitioner purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3-percent convertible debenture bonds, due September 1, 1956, as follows:

August 16, 1944—$11,000 at 121⅛	$13,351.25
August 16, 1944—$2,000 at 121	2,425.00
August 22, 1944—$37,000 at 121¼	44,862.50

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share.

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941. The indenture provided in part that on not less than thirty days' notice the bonds

might be redeemed by the Company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%."

The indenture further provided that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds) to convert * * * the principal of any such Debenture Bonds * * * into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the Company of cash equal in amount to the excess of the conversion price over $100.

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest.

In his return for the taxable year petitioner claimed as a deduction, in computing net income, amortization of the premium paid with respect to his bonds in the amount of $8,638.75, representing the difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds at 104.

These bonds were the only premium bonds purchased or owned by petitioner in 1944. They were not part of the stock-in-trade of petitioner or includible in any inventory of petitioner at the close of the taxable year, or held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by petitioner as an investment.

Petitioner, in 1944, did not sell any of the bonds or exercise his right of converting them into capital stock of the Company.

Opinion

OPPER, *Judge:* When the coupon rate of interest carried by a bond issue exceeds the going rate for obligations of comparable desirability, the market will tend to place a premium on the bonds. If bonds are purchased for investment under such circumstances,

the premium paid must be recovered tax-free out of the earnings of the bond [11] very much as depreciation must be recovered out of the income of depreciable property if the true distinction
41 between income and recovery of capital is to be preserved. Cf. *United States* v. *Ludey*, 274 U. S. 295. With this objective in mind,[12] Congress in 1942 added provisions to the Internal Revenue Code permitting the amortization of bond premium by deductions from gross income.[13]

42 A complication bound to arise was the amortization of premium on bonds callable prior to maturity. Such obligations although not included in the statute are covered in a subdivision of the regulations dealing with "Callable and Convertible Bonds." [14]

---

[11] "• • • The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss." (Statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury, Hearings before the Committee on Ways and Means on Revenue Revision of 1942, p. 90.)

[12] "Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provisions should be made for their avoidance.

"The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. Holders of taxable bonds not only pay a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital 'lost' at maturity. Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it.

"The treatment proposed is mandatory to all taxpayers with respect to wholly tax-exempt bonds and elective to all with respect to bonds fully taxable. In the case of partially tax-exempt bonds, it is mandatory to corporate taxpayers and elective to all other taxpayers.

"The amortization provision is found in section 119 of the bill and its operation is described in detail later in this report." (H. Rept. No. 2333, 77th Cong., 2d Sess., p. 47).

[13] "SEC. 23. • • •

"(v) *Bond premium deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125."

"SEC. 125. AMORTIZABLE BOND PREMIUM.

"(a) *General rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction,

• • • • • •

"(b) Amortizable bond premium.—

"(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

"(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

"(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

"(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

"(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

[14] Regulations 111:

"SEC. 29.125-5. *Callable and convertible bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date

43 The debentures purchased by petitioner in the tax year and which form the subject of this controversy were both callable and convertible. They were currently callable at the option of the obligor at any time on thirty days' notice at 104 percent of face. They were convertible at any time at the option of the holder into common stock of the obligor upon payment of the difference between the face of the bond and 140 percent of par.

Petitioner purchased the debentures at approximately 121 when the common stock of the obligor was selling at 163. Relying upon his interpretation of the statute and the regulations, petitioner deducted the difference between 104, the call price, and 121, his purchase price or basis, as a premium. The entire deduction was taken in the year before us, on the theory that the bond could have been called in that same year, and that in that event the entire premium would have been lost.

Respondent does not dispute such treatment in the case of a bond callable within the current year, but rejects petitioner's claim here because of the convertible feature of the debentures. His position was set forth in a ruling issued in 1945, dealing with the same issue of debentures as that now in controversy.[15]

44 Respondent's reasoning to justify rejection of the claimed deduction is not without force. He says in effect that what Congress was dealing with when it enacted section 125 was, as we

---

will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date, if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof."

[15] "* * * If the call provisions of these bonds were to be considered wholly apart from other attendant circumstances, the taxpayer might select the 31st day after the date of purchase as the 'earlier call date,' even though the bonds were not actually called on that date or notice of call had not been given.

"Section 29.125-5 of Regulations 111, provides, however, that the fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. The qualification in itself indicates that other factors may arise which would preclude the application of section 125 of the Code to such bonds.

"The bonds have been selling for approximately 123 and the common stock of the American Telephone and Telegraph Company has been selling for about 163. It will thus be seen that the $123.00 cost of such bond plus the $40.00 conversion fee equals $163.00, the same price for which the stock can be purchased on open market. For nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock into which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option. This $23.00, therefore, is not a true bond premium such as would normally be amortized out of gross interest earnings in order to exclude capital recovered under the guise of interest and thus determine the effective yield of the security.

"This office is accordingly of the opinion that the excess of the amount of the basis of these bonds over the amount payable at maturity may not be amortized under section 125 of the Internal Revenue Code. * * *" (1945 P. H., ¶ 76, 157; 1945 C. C. H., ¶ 6139).

have seen, the investment premium paid in excess of the call or maturity price of an obligation which was required to be paid in order to purchase interest income. Respondent's regulations, to be sure, do not provide that no bond "convertible into stock" is within the definition of an amortizable obligation, but that "the fact that a bond is * * * convertible into stock does not, in itself, prevent the application of section 125." [16] This, however, advances us only to the point that the mere aspect of convertibility may not necessarily affect the possibility of the payment of an investment premium. Such would be the situation where the relationship between the conversion figure and the market price of the obligor's stock, eliminated value from the conversion privilege. See Badger,[17] "Valuation of Industrial Securities," 42. But in the present case, both the call price and the conversion figures indicate that the premium was paid, not for the investment feature of the bond, but for the rights of conversion.

The final reference in the regulation to a convertible obligation is that contained in the last sentence of the subdivision previously quoted,[18] reading as follows:

"* * * A convertible bond is within the scope of section 125 if the option to convert [on a date certain specified in the bond] rests with the holder thereof."

If this statement could be taken as fairly interpretative, and whatever its meaning may be,[19] it seems clear that it could, under no circumstances, apply to these facts, and hence could be disregarded here. The debentures held by petitioner were convertible on any date from the minute he acquired them to their possible future call for redemption and consequently not on "a date cer-

45

---

[16] See footnote 4, *supra*.

[17] "* * * The value of convertible bonds is, in fact, dependent on either one of two factors. As long as the value of the issue into which the bond is convertible remains below the point where conversion is profitable, just so long will the value of the bond be dependent entirely on its investment status. When the value of the former rises, however, the value of the convertible issue is a function of two factors, the rate of conversion and the price of the issue into which it may be converted. This may be expressed mathematically as follows:

Investment value of convertible issue	I
Conversion rate	R
Market price of stock	P
Value of convertible bond	V

I determine V if I is greater than $\frac{P}{R}$; Otherwise $V = \frac{P}{R}$."

[18] See footnote 4, *supra*.

[19] Respondent suggests the following in his brief as an example of the purpose of that portion of the regulations (p. 22):

"A bond callable at any time on 30 days' notice, is convertible into stock only on January 1, 1910 (a date certain specified in the bond). It would be possible for the issuer, by exercising the call privilege, to defeat the bondholder's conversion right so that any premium paid for the bond might be lost thereby. This might justify the allowance of the deduction for amortization of premium where conversion is provided for on a date certain specified in the bond; whereas, when no date certain is specified, the holder of the bond would be protected by his right to convert, which could not be defeated by the mere exercise of the call privilege."

tain." The result of this sentence would then be neutral and leave open for consideration the question whether the section covered such convertible bonds as those held by petitioner.

The difficulty with respondent's entire position, however, is that it ignores the interpretation which Congress itself placed upon the legislation. In both the Ways and Means Com-
46 mittee and Finance Committee reports,[20] there appears in identical language the following:

"The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of the section.*" [Emphasis added.]

The final statement is unequivocal and precisely includes the bonds in controversy. Petitioner's application of the provision to his situation and his computation of the deduction are thus squarely justified by the expression of congressional intent. The portion of the sentence of the regulation quoted above which is enclosed in brackets appears to be a gratuitous addition by respondent not founded upon the statutory language and directly in conflict with its legislative history. We are accordingly unable to ascribe to it the validity which would result in authorizing respondent's position in this proceeding. We see no choice but to disapprove the deficiency.

Reviewed by the Court.

Decision will be entered under Rule 50.

47 *Decision*

[Tr. 143]

[Caption omitted]

Respondent having on July 2, 1948, filed a recomputation of tax for entry of decision as in accordance with Findings of Fact and Opinion of the Court, promulgated June 2, 1948, and petitioner having concurred therein, now, therefore, it is

[20] H. Rept. No. 2333 (77th Cong., 2nd Sess.), p. 80. S. Rept. No. 1631 (77th Cong., 2nd Sess.), p. 94.

Ordered and Decided: That there is a deficiency in income tax for the year 1944 in the amount of $216.97.

(Signed) CLARENCE V. OPPER,
Judge.

Enter: Jul. 13, 1948.

* * * * * *

Statement of points to be relied upon

[Tr. 146–147]

In the United States Court of Appeals for the Second Circuit

T. C. Docket No. 13943

COMMISSIONER OF INTERNAL REVENUE, PETITIONER ON REVIEW

v.

CHRISTIAN W. KORELL, RESPONDENT ON REVIEW

Statement of points

Now comes the Commissioner of Internal Revenue, the petitioner on review herein, by his attorneys, Theron L. Caudle, Assistant Attorney General, and Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and hereby asserts the following errors on which he intends to rely in this review:

The Tax Court of the United States erred:

1. In holding and deciding that the premiums paid for bonds callable for redemption on 30 days' notice is
48 amortizable in full in year of acquisition under Sections 23 (v) and 125 of the Internal Revenue Code, notwithstanding the premium may have been due entirely to accompanying privilege of converting into obligor's stock at a price below current market value.

2. In holding and deciding that the phrase appearing in Sec. 29.125–5 of Regulations 111 "on a date certain specified in the bond" is a gratuitous addition by the Commissioner not founded upon the statutory language and is directly in conflict with its legislative history.

3. In failing to reject the petitioner's claim for amortization of bond premiums because they were not true bond premiums within the intendment of the Statute and Regulations, such as would normally be amortized out of gross interest earnings in order to exclude capital recovered under the guise of interest.

4. In failing to hold and decide that no part of the so-called premium on the 15-year 3% convertible debenture bonds of the American Telephone & Telegraph Co. was deductible in the year 1944 under Sections 23 (v) and 125 of the Internal Revenue Code as amortization of the premium over the call price for the reason that the excess of the purchase price over par represented the market value of the conversion option and was not a true bond premium.

5. In entering its decision wherein it ordered and decided that there is only a deficiency of $216.97 in income tax for the year 1944.

6. In that its decision is not supported by the evidence.

7. In that its decision is contrary to law and regulations.

(S) THERON L. CAUDLE,
Assistant Attorney General,
(S) CHARLES OLIPHANT,
Chief Counsel,
Bureau of Internal Revenue,
Counsel for Petitioner on Review.

49 Service of a copy of this statement of points is hereby admitted this 9th day of December 1948.

(S) PAUL L. PEYTON,
15 Broad Street, New York 5, New York,
Counsel for Respondent on Review.

1481 United States Court of Appeals for the Second Circuit

No. 202—October Term, 1948

(Argued May 11, 1949—Decided June 8, 1949)

Docket No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

Before: CHASE, CLARK and DOBIE, *Circuit Judges.*

On petition for review of the decision of the Tax Court of the United States

Petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States, 10 T. C. 1001, disallowing a deficiency he had assessed in the federal income tax of Christian W. Korell for the year 1944. Decision affirmed.

1482 FRED E. YOUNGMAN, Sp. Asst. to the Atty. Gen., of Washington, D. C. (Theron Lamar Caudle, Asst. Atty. Gen., and Ellis N. Slack and Robert N. Anderson, Sp. Assts. to the Atty. Gen., all of Washington, D. C., on the brief), *for petitioner.*

PAUL L. PEYTON, of New York City (John J. Fogarty and Frederick H. Bruenner, both of New York City, on the brief), *for respondent.*

CLARK, *Circuit Judge:*

This case presents a problem as to the nature of the "amortizable bond premium" which was first allowed as a deduction from gross income for federal income-tax purposes in 1942. The taxpayer has claimed such a deduction on his 1944 tax for the excess cost to him, over the amounts payable, of certain bonds which were callable at the debtor's option and convertible at his option into shares of the debtor's stock. His contention has been sustained by the Tax Court as against the Commissioner's contention that the statutory deduction is allowable only for a "true bond premium" and that the excess of cost in the case of convertible bonds of the kind here in issue is not of that nature.

Judge Opper for the Tax Court has written a carefully reasoned opinion, 10 T. C. 1001, which was reviewed by the whole court and which we think fully meets the issues presented by the Commissioner. In it he states the facts, which were stipulated, the rather lengthy statutory provision and treasury regulations, and certain of the committee reports explaining the statutory provision when it was adopted. Since the material is thus available, we
1483 shall merely refer to it where apposite without full quotation.

In August, 1944, respondent purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3 percent convertible debenture bonds, due September 1, 1956, at prices ranging from $121 to $121¼ per $100 principal and a total cost of $60,638.75. At that time the bonds were subject to call by the company on thirty days' notice at 104%; and, indeed, they were so called and paid on September 1, 1947. In his 1944 return, respondent claimed as a deduction the amount of $8,638.75, representing the difference between the cost, stated above, and the call price of $52,000. It is this deduction which the Commissioner disallowed in making his deficiency assessment and which is restored by the decision of the Tax Court, now before us on the Commissioner's petition for review.

To round out the picture, certain additional facts must be adverted to; indeed, these become crucial to the discussion. Under the terms of the bond respondent had the option, during all times

here important, of converting the bonds into stock of the company by surrendering $100 principal of the bond issue and $40 in cash in exchange for each share of stock received. On the dates when he purchased the bonds the average selling price of the stock was $163.1875 and $163.6875 per share. The Commissioner, in arguing that the excess paid for the bonds here over their face value represented the value of the conversion rights, stresses the correspondence in value between the price of each bond plus $40 and the current quotation for the stock into which it could be converted. He adds that "it would be naive to assume that the bonds here involved were purchased at such exorbitant prices purely for investment purposes." We shall avoid the charge of naiveté by expressing no dissent; whatever respondent may actually have done with these bonds after 1944, certainly it would be
1484 perfectly normal to expect a holder to sell them in due course after the proper interval to take advantage of the lower rates for capital gains.[1] And the obvious advantage, taxwise, of transactions of this form might make such convertible bonds all the rage of security markets. Nevertheless the difficulties of a judicial attempt to remodel legislation to deal with such a situation at once fairly and not overdestructively remain obvious.

Let us then turn to the statute which still remains the best indicator of the legislative intent. *Ex parte Collett*, S. Ct., May 31, 1949; *Gemsco v. Walling*, 324 U. S. 244, 260. After having provided for the deduction of "amortizable bond premium," 1 R. C. § 23(v), it goes on to define the latter. I. R. C. § 125, as added by § 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798. In summary it provides that the "amount of bond premium" shall be determined with reference to the (in this case) cost and the "amount payable on maturity or on earlier call date," and "the amortizable bond premium" of the taxable year shall be "the amount of the bond premium attributable to such year." I. R. C. § 125 (b) (1) and (2). As Judge Opper has stated the objective, "the premium paid must be recovered tax-free out of the earnings of the bond very much as depreciation must be recovered out of the income of depreciable property if the true distinction between income and recovery of capital is to be preserved."[2] Finally subd. (d), "Definition
1485 of Bond," provides: "As used in this section, the term 'bond' means any bond, debenture, note, or certificate or other

---

[1] Such course, we are told, was actually followed by another taxpayer as to this same bond issue in a case where likewise the Tax Court reversed the Commissioner. *Khoong v. Commissioner*, 1948 Prentice Hall T. C. Memorandum Decisions, ¶ 48,095, now pending on appeal to the Court of Appeals for the Ninth Circuit.

[2] "Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance." H. R. Rep. No. 2333, 77th Cong., 2d Sess., 47, 1942, quoted by the Tax Court below.

evidence of indebtedness, issued by any corporation and bearing interest," and then goes on to exclude bonds constituting stock in trade of the taxpayer or held primarily for sale to customers in the ordinary course of business.

Thus it will be seen that there is here provided a complete statutory scheme applying in general terms to all forms of bonds, including—as is shown by the reference to the "call date"—callable bonds. Hence there is no sound basis for excluding from the operation of the statute convertible bonds, even though the premium paid on them might well be due more to the privilege of conversion than to other features, such as the callability of the bonds at a premium. And this, it is made clear by the Committee Reports, was the view of the legislators, for they so state in language relied upon by the Tax Court, so directly to the point that we shall quote it, *viz:* "The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, if the option to convert the bond into sock rests with the owner of the bond, the bond is within the purview of this section." H. Rep. No. 2333, 77th Cong., 2d Sess., 80 (1942–2 Cum. Bull. 372, 433, 434); Sen. Rep. No. 1631, 77th Cong., 2d Sess., 94 (1942–2 Cum. Bull. 504, 576).

The intent therefore to include convertible bonds generally within the operation of the statute cannot be questioned, and the Commissioner is really forced to the rather extreme posi-
1486 tion of saying that only the particular type of convertible bond here in issue does not have the "true bond premium," which alone, according to his view, is to be amortized. For this he cites as significant the precise wording of an applicable Treasury Regulation. In fact, the section, after permitting "the method of amortizing bond premium regularly employed by the holder of the bond" to be used "if such method is reasonable," then provides that the method in all other cases shall be "in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary." I.R.C. § 125 (b) (3) (A) and (B). This appears to concern more the method of computing the yearly deductions than the allowance of the deductions themselves. At any rate, § 29.125 of Treas. Reg. 111 contains extensive and detailed provisions which, *inter alia*, accept complete application of the section to both callable and convertible bonds. The provision most in point here, subsec. 5 of § 29.125 of Treas. Reg. 111, first states:

"The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125." It then goes on to provide that in the case of a callable bond the earlier call date is considered the maturity date for application of the statute and for the spreading of the bond period over the period involved.[4] It concludes, "A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof." This last sentence (and particularly the words "on a date certain") is the one about which discussion has hinged.

1487 In its decision the Tax Court concluded that the words involved appear to be "a gratuitous addition by respondent not founded upon the statutory language and directly in conflict with its legislative history." Accordingly it found itself unable to ascribe to the provision the validity which would result in supporting petitioner's position herein. Petitioner now assails this holding as in itself gratuitous in that the language, "does not necessarily exclude bonds convertible at any time by the holder," and the exclusion should be considered accomplished by definition of "true bond premium" within the meaning of the statute itself. We can well agree with the argument that these words do not necessarily reach our case, which may be one not specifically covered by the regulations beyond the generality of statement elsewhere contained in them. But that gets us little further along, for we must still give effect to the statute which contains no suggestion of the narrowing concept now urged to be a part of it. Nor does petitioner suggest any definition of his concept of sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities hereafter. In short, the narrow rule of exclusion does not appear to us as justifiable either on grounds of equity or as a reasonable interpretation of the statutory language. The particular option which is relied on to remove the transaction from the statutory grant is at most only a bit more extensive—or more valuable—than one admittedly within it. The difference is thus one merely of degree and not of kind. Indeed, the difficulty with petitioner's position is that it requires the making of narrow and quite possibly unfair distinctions between varying bond issues without warrant in the general language employed or in the legislative history. Why should a bond callable at 107 (as these originally were) have this tax option denied to a holder thereof only when it is accompanied by the grant

[4] Hence the taxpayer here properly treated as the earliest call date for his bonds the date which was thirty-one days subsequent to his purchase and therefore he deducted the entire premium as a loss during the year 1944—a method of computation which is not challenged by the petitioner.

1488 of a privilege to convert into stock, or more particularly only when it is accompanied by the grant of such privilege of conversion when it is exercisable at any time, instead of at a future specified time or interval of time? To attempt to make such distinctions in a statute so broadly and generally worded seems to us to be trespassing beyond the judicial, and upon the legislative, process.

Affirmed.

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 8th day of June one thousand nine hundred and forty-nine.

Present: Hon. HARRIE B. CHASE, Hon. CHARLES E. CLARK, Hon. ARMISTEAD M. DOBIE, *Circuit Judges*.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

Appeal from the Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

ALEXANDER M. BELL,
Clerk.

United States Court of Appeals, Second Circuit

COMMISSIONER OF INTERNAL REVENUE

v.

CHRISTIAN W. KORELL

202

Judgment

United States Court of Appeals, Second Circuit. Filed June 8, 1949. Alexander M. Bell, Clerk.

No. 21225

In the United States Court of Appeals for the Second Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KOSELL, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

PETITION FOR REHEARING

United States Court of Appeals, Second Circuit. Filed June 24, 1953. A. M. Bell, Clerk.

1 In the United States Court of Appeals for the Second Circuit

No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

Petition for rehearing

To the Honorable United States Court of Appeals for the Second Circuit and to the Judges Thereof:

Comes now the petitioner, the Commissioner of Internal Revenue, and in accordance with Rule 28 of this Court presents his petition for rehearing.

This case was argued on May 11, 1949. An opinion was filed June 8, 1949, affirming the decision of the Tax Court, disallowing a deficiency assessed for the year 1944.

This Court determined that the approximate sum of $17 per bond paid in excess of the call price was "amortizable bond premium" within the meaning of Section 125 of the Internal Revenue Code, despite the fact that it was patent that the excess price was paid as consideration for the privilege of purchasing stock

2 at approximately $20 below the market price. It is respectfully submitted that the determination of this Court on the novel question presented was based upon a serious and fundamental misconception as to the nature of the deduction intended by Congress. In the view of the Commissioner the error of this Court is three-fold. First, the Court failed to give effect to the relevant legislative history which demonstrates conclusively that the excess payments made here are not "amortizable bond premium" within the meaning of the statute and cannot conceivably serve as the basis of the claimed deduction when once the purpose of the statute is understood. Secondly, the Court appears to have erred in so far as it indicated that the construction of the statute urged by the taxpayer was required by the language of Section 125; whereas in fact Section 125 contains no definition of "amortizable bond premium" but states only the method of computing the amount of the premium. Thirdly, the Court apparently misconceived the basis of the Commissioner's contention,

attributing to the Commissioner a reliance on certain Treasury Regulations to support the contention that the amount claimed as a deduction was not bond premium. The consequence of this misconception is that the Commissioner's real contention has not as yet been satisfactorily answered either by the taxpayer, the Tax Court, or this Court.

1. The decision of this Court attributes to the term "amortizable bond premium" a meaning not only out of harmony with the concept as commonly understood but which is furthermore wholly unwarranted by and indeed in the teeth of the demonstrated legislative intent in granting the deduction claimed here. "Amortizable bond premium" is the excess payment over the call price of a bond which has been paid in order to obtain a rate of in-
3 terest in excess of the average market yield, and which is thus reflected and included in each distribution of bond "interest". Bond premium is not any payment over the call price made in conpection with the purchase of a bond regardless of the nature or purpose of the payment. It is not a payment manifestly made for an option to purchase stock as that here involved. Even were the legislative history unconvincing it could be demonstrated that as a matter of common understanding a bond premium represents the excess capital paid to obtain a higher rate of interest. That this was the meaning intended by Congress is conclusively demonstrated by the Report of the House Ways and Means Committee (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 47 (1942–2 Cum. Bull. 37[illegible]410)) setting forth the reason for the deduction of "amortizable bond premium" as follows:

"Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance.

"The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. *Holders of taxable bonds not only pay a tax as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital 'lost' at maturity.* Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it." [Italics ours.]

4 The Committee Report demonstrates that bond premium is that capital which has been paid to obtain a higher rate

of interest than the average market yield and which is thus included as a portion of each of the interest payments. As the Committee Report points out, the purpose of the deduction claimed here was to allow the taxpayer to recover out of the interest earnings that portion of the purported interest which was really capital or premium. In the instant case it may be observed that the 3% interest paid on the bonds was the average rate of interest. It was only interest and included no capital to be recovered. This followed from the fact that the payments made in excess of the call price in connection with the purchase of the bonds were not made to obtain above average interest but were made for the purchase of what were in essence stock options. In short, the payments were not bond premium; they were in no wise reflected or included in the interest distributions; and no reason existed to allow for the recovery out of interest of that which was not attributable to or in any way reflected in the interest.

That Congress used the term "amortizable bond premium" in the sense urged by the Commissioner in enacting Section 125 is further demonstrated by the testimony of Randolph Paul, in his capacity as Tax Advisor to the Secretary of the Treasury, given before the House Ways and Means Committee, and explaining the nature of the deduction contemplated and the reason for granting it. His testimony as set forth before the House Ways and Means Committee (House Hearings on the Revenue Act of 1942, Vol. I, p. 90) appears as follows:

"(d) *Amortization of bond premium.*—Holders of a tax-exempt security purchased at a premium are today in the unique position of being relieved of tax on the interest paid on the security and of receiving a deductible loss upon redemption or other disposition of the security to the extent of the premium. As *the premium at which a bond is obtained represents to the holder* merely an *effective yield lower than the actual interest rate*, the holder is entitled merely to tax exemption solely with respect to such effective yield. *The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss.* On the other hand, the holder of a taxable security purchased at a premium is in the unfortunate position of being taxed upon the interest at high rates and of receiving a capital loss upon redemption whose deductibility is subject to the restrictions placed upon capital losses. *Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.*

"*Proper tax treatment in both situations may be obtained through amortization of the premium.* It is suggested that such amortization be mandatory for wholly tax-exempt securities and

for partially tax-exempt securities held by a corporation. For all other securities the amortization should be at the taxpayer's election." [Italics supplied.]

As Mr. Paul points out, the premium represents the amount paid to obtain an interest rate in excess of the true average yield and the purpose of Section 125 was to allow the taxpayer to deduct the difference between the true average yield and the actual interest rate which was simply a return of capital, or premium. Again in terms of the case presented to this Court, it is patent that the 3% interest paid represented the yield of the bond and "true income to the taxpayer", and did not include or reflect any capital or premium. The excess payment as above noted, which was made in this case, was entirely unconnected with the interest of the bond. When once the legislative history is properly understood, it becomes apparent that this Court has approved a deduction which is wholly unwarranted by the statute and at variance with the legislative history. Moreover, it produces the garish result of permitting the taxpayer to recover out of interest something which has never been lost. Since the excess payment was made not for high interest but for stock options the taxpayer is ever in a position to recover the excess payment simply by converting the bonds and thus exercising the option. There is nothing for the taxpayer to recover from interest payments. Although this Court and the Tax Court recognized that premium "must be recovered tax free out of the earnings of the bond" (Op. p. 4), both courts ignored the basis of the deduction demonstrated by the legislative history.

2. It is respectfully submitted that this Court erred in concluding that the statute itself required the allowance of the deduction claimed by the taxpayer.[1] Even were it true that the statute contained an apparently unambiguous definition of "amortizable bond premium," the Court ought to have given effect to the actual purpose of Congress as demonstrated by the legislative history, especially since the deduction here claimed is wholly at variance with the legislative purpose. *United States* v. *Amer. Trucking Ass'ns*, 310 U. S. 53; *Harrison* v. *Northern Trust Co.*, 317 U. S. 476; *Mitchell* v. *Cohen*, 333 U. S. 411; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Armstrong Co.* v. *Nu-Enamel Corp.*, 305 U. S. 315, 333.

---

[1] An analysis of the framework of the statute supports the Commissioner's position. As demonstrated, the purpose of the statute was to limit the payment of the tax to the true yield or true interest and allow for the recovery, by deduction, of the difference between the true yield and the actual rate of interest which is simply premium returned. For this reason Section 125 (a) (2) provides that there will be no deduction where no part of the purported interest is taxable. Where no part of the distribution is taxable there is no reason to allow for the deduction of that portion which is not true interest but is premium.

7 Section 125 (b) (1) does not contain a definition of "amortizable bond premium." It states only the method of computing the amount of the premium, which is by reference to the amount of the basis and the amount payable at maturity or on earlier call date. A statement of the method of computation of the amount of premium is not helpful to the Court in determining whether or not a payment is premium. If, for example, one of the paragraphs attached to an evidence of indebtedness provided that the holder, having paid $20 over and above the redemption price, would be entitled to purchase gold or silver, or indeed any other commodity or security at $20 below market price, it would be apparent that the excess payment was not bond premium but merely represented the price of what was in essence an option. Certainly Congress, in stating the method of computing the amount of bond premium did not intend to and did not in fact state that any amount paid in connection with a bond over and above the redemption price of the bond would be recoverable out of interest regardless of the nature or purpose of the payment and regardless of the fact that the payment was in no way reflected in the interest earnings.

3. A reading of the entire opinion of the Court reveals that the Commissioner was apparently not successful in presenting and explaining his position. The Court devoted a considerable portion of the opinion to demonstrating that the mere fact that a bond is callable or convertible does not remove it from the scope of Section 125. The Court also demonstrates that the bonds involved here are bonds within the meaning of the statute. The Commissioner is in full agreement with the Court in these respects. The question for decision however is whether the excess payments which the taxpayer seeks to deduct are "amortizable bond premium." The Court states in its opinion that in attempt-
8 ing to prove that the bonds do not involve "true bond premium," the Commissioner relies upon the precise wording of the applicable Treasury Regulations. This is an inaccurate statement of the Commissioner's position. The principal contention of the Commissioner is in no way dependent upon the language of the Treasury Regulations or specifically on the use of the phrase "on a date certain specified" as utilized in the Regulations. The Commissioner's position, as previously stated, is that, as a matter of common understanding, and furthermore, as demonstrated by the legislative history, "amortizable bond premium" represents the amount which has been originally paid to obtain a higher rate of interest and which is reflected in each interest payment as the difference between the average or true yield of the bond and the actual interest rate. It is not true that the Com-

missioner's position "requires the making of narrow and quite possibly unfair distinctions between varying bond issues" (Op. p. 7). The distinction is not between bond issues, but between those payments which are "amortizable bond premium" and those which are not. A convertible bond may be purchased at a price in excess of redemption value under circumstances that clearly indicate that the excess payment is truly bond premium and is reflected in and thus recoverable from interest earnings. This however is not the case here.

Wherefore the Commissioner respectfully prays that a rehearing of this proceeding be granted for the above mentioned reasons.

Respectfully submitted.

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
SUMNER M. REDSTONE,
Special Assistants to the Attorney General.

JUNE 1949.

9 *Certificate of Counsel*

The petitioner herein, by its attorneys, hereby certifies that the foregoing motion is not presented for the purpose of delay or vexation, but is, in the opinion of counsel well founded and proper to be filed herein.

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
SUMNER M. REDSTONE,
Special Assistants to the Attorney General.

JUNE 1949.

1743 United States Court of Appeals, for the Second Circuit

No. 202—October Term, 1948

(Petition filed June 22, 1949—Decided July 14, 1949)

Docket No. 21225

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

CHRISTIAN W. KORELL, RESPONDENT

Before: CHASE, CLARK, and DOBIE, *Circuit Judges.*

On petition for rehearing

THERON LAMAR CAUDLE, Asst. Atty. Gen., and Ellis N. Slack and Sumner M. Redstone, Sp. Assts. to the Atty, Gen., all of Washington, D. C., *for petitioner.*

PER CURIAM:

While we do not consider that we have misunderstood the Commissioner's position, at least to the extent asserted in his
1744 earnest and vigorous petition for a rehearing, yet it is desirable, against the event that the case may go higher, that his contentions before us be not misstated. Accordingly we set forth his position in his own words, viz, "that, as a matter of common understanding, and furthermore, as demonstrated by the legislative history, 'amortizable bond premium' represents the amount which has been originally paid to obtain a higher rate of interest and which is reflected in each interest payment as the difference between the average or true yield of the bond and the actual interest rate." This view that the quoted words have a single meaning so well understood that the statutory explanation can be considered only a method of computation and not a definition must necessarily control and limit the word "premium" itself. So the Commissioner says: "Bond premium is not any payment over the call price made in connection with the purchase of a bond regardless of the nature or purpose of the payment. It is not a payment manifestly made for an option to purchase stock as that here involved. Even were the legislative history unconvincing it could be demonstrated that as a matter of common understanding a bond premium represents the excess capital paid to obtain a higher rate of interest."

But this scholarly accountant's concept which is not so naturally a legal or a lay mandate, has not appealed to us, as it did not to the

several members of the Tax Court, 10 T. C. 1001, as being of universal significance. Nor did the legislative history—which was, in fact, cited in the Tax Court's decision and referred to by us—show so precise and exclusive a meaning ascribed to a fairly ordinary word. As a matter of fact, this restricted meaning of "premium" is definitely rejected in the law of trusts, and in the apportionment of principal and income to life tenant and remainderman, where the general idea of amortization has had perhaps its most
1745 extensive development in the law. Thus where amortization is required, a trustee is expected to restore to principal the excess amount he has expended, not some lesser theoretic amount resting on an unknown variable such as the assumed normal rate of interest on money. 1 Restatement, Trusts, § 239, comment f, 1935; 2 Scott on Trusts, § 239.2, 1939; 4 Bogert, Trusts and Trustees, § 831, 1935. Indeed from the time of Holmes on, the idea that the premium is paid solely for interest above the market rate has been attacked as clearly a fiction. *Hemenway* v. *Hemenway*, 134 Mass. 446, 449; *New England Trust Co.* v. *Eaton*, 140 Mass. 532, 544, 545, 4 N. E. 69 77, 78; 45 Yale L. J. 156; 20 Minn. L. Rev. 203; 34 Mich L. Rev. 448.[1] The passages quoted by the Commissioner seem to us no more than apt illustration and not at all a suggestion of exclusion of all else from the concept "premium," or of limitation of the broad statutory language. And the demonstration seems complete with the flat statement in the committee reports relied on by both the Tax Court and us—without the qualifying provisions surely natural if the Commissioner's projected limitations had been in the minds of the legislators—that "in the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section."

The petition for rehearing is denied.

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 14th day of July, one thousand nine hundred and forty-nine.

Present: Hon HARRIE B. CHASE, Hon. CHARLES E. CLARK, Hon. ARMISTEAD M. DOBIE, *Circuit Judges*.

---

[1] "That the premium is paid solely in respect of interest, which is the assumption supporting amortization, is a fiction, is demonstrated by any survey of bond prices." 45 Yale L. J. 156, 158, discussing *Old Colony Trust Co.* v. *Comstock*, 290 Mass. 377, 195 N. E. 389, 101 A. L. R. 1. The author of the annotation to this case, 101 A. L. R. 7, 9, has tried valiantly here and elsewhere (see 48 A. L. R. 682, 131 A. L. R. 1426) to argue that the problem in property law is only a simple mathematical and financial one, but without success with the courts. The uncertainties involved afforded one of the reasons for the rejection of a duty to amortize in the Uniform Principal and Income Act, § 6, 9 U. L. A. 593, 594, 599; *cf.* 1929 Handbk. Nat. Conf. of Commissioners on Uniform State Laws 290–293.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

A petition for a rehearing having been filed herein by counsel for the petitioner,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

ALEXANDER M. BELL,
Clerk.

United States Court of Appeals, Second Circuit

COMMISSIONER OF INTERNAL REVENUE

v.

CHRISTIAN W. KORELL

Order

United States Court of Appeals, Second Circuit. Filed July 14, 1949. Alexander M. Bell, Clerk.

United States of America, Southern District of New York

I, Alexander M. Bell, Clerk of the United States Court of Appeals for the Second Circuit, do hereby certify that the foregoing pages, numbered from 1 to 48, inclusive, contain a true and complete transcript of printed portions of the record and proceedings had in said Court, in the case of

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL, RESPONDENT

as the same remain of record and on file in my office.

In testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, in the Second Circuit, this 28th day of September in the year of our Lord one thousand nine hundred and forty-nine, and of the Independence of the said United States the one hundred and seventy-fourth.

[SEAL]

ALEXANDER M. BELL,
Clerk.

U. S. GOVERNMENT PRINTING OFFICE: 1949

Supreme Court of the United States

No. 384, October Term, 1949

Order allowing certiorari

Filed December 5, 1949

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted. The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Douglas took no part in the consideration or decision of this application.